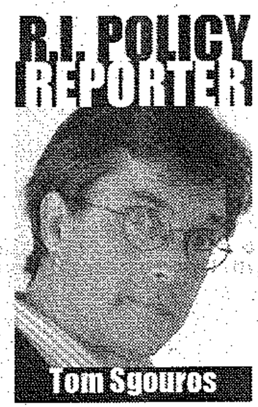
State pensions: Who is the liability?

The governor has announced his plans to cut 1,000 state employees and to cut $50 million in state spending and another $50 million in benefit costs for the remaining state employees. I can say stuff like that, too. Watch: I will cut all 15,353 state employees! Except the lifeguards at Scarborough. Of course I'm not the governor, so it's a tiny bit less credible, but not by much. Until he starts to say who he will cut, from which departments, and which services will be sacrificed to make this plan work, it's all just words, about as valuable as mine.



While we all wait for the governor actually to make one of those tough decisions he's always talking about, here's something to consider: he is proposing cutting employee benefits, including pensions, for state employees. William Murphy, the Speaker of the House, is proposing a shift in the kind of pensions we offer to state employees. (Which will actually cost more in the short term.) What neither of them will say is that we could lower pension costs for the state, as well as for all the schools, by about $43 million or more without reducing benefits or paying another dime. All it would take would be a signature, but Governor Carcieri won't consider it.

The story isn't too complicated, but there are four important things to understand about it. First, and this will come as a surprise to many, current state employees and teachers pay almost all of the cost of their own pensions. State employees pay 8.75 percent of their salaries and teachers pay 9.5 percent into their pension funds. This current year, the employer (the state and the schools) only pay about 1.5 percent of payroll to match what are called the "normal costs," which are the expected costs of paying the pensions of the employees who are in the system now.

Second, the system has a big "unfunded liability," which is the difference between what the system expects to have and what it expects to pay, in the future. Paying this off is where the real expense is, and the state and schools are paying about 20 percent of payroll for that. For a long time, state pensions were underfunded. We gave legislators, judges and other favored employees pension credit for time in the military, for time in other pension systems, and sometimes just for having a nice smile. These abuses have been largely (though probably not completely) eliminated, but their legacy lingers on in the unfunded liability. What's more, for a couple of years after the credit union crisis of the early 1990s, the state skipped its payments entirely. And some predictions about investment returns, or the death rates of retirees turned out to be wrong. (Actuaries aren't soothsayers, and they do get things wrong, but they tend to be high some years and low other years, so it's likely that poor predictions aren't the real problem.)

Third, in 1999, the state began a program to pay down the unfunded liability. This is a good thing to do, but it's important to understand why it's a good thing to do. For private businesses, getting the unfunded liability down to zero is important because businesses can go out of business, and you want the pension system to be able to survive that. The state isn't going to go out of business, but keeping the unfunded liability small helps reduce "volatility" in future pension payments. This is actuary-speak for sudden cost increases. So, doing the responsible thing, in 1999, the state decided to pay off the unfunded liability in 30 years, by 2029.

Fourth, no sooner had the state decided to pay down the liability than the stock market tanked. So for the first five years, the extra payments weren't enough to make up for the investment losses. They have by now, but we're still on track to pay off the liability by 2029. Except now instead of a 30-year payment schedule, we have a 22-year schedule, and the payments are higher, just like a mortgage would be. If we restarted the clock, and moved the payoff date to 2037, state payments would drop by $28 million and the cities and towns would save $15 million. Ask your local school principal if that would be a good idea.

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Sounds radical, no? Well, there are radicals in North Dakota, Iowa and Kentucky who do this every year for retirement systems there. Oklahoma, too, and they use a 40-year schedule. Actuarie[illegible] this an "open" amortization sc[illegible] and it's not at all uncommon. [illegible] don't get to a date certain for paying off the liability, but you do make progress on it every year, and that's what being prudent means.

What being prudent doesn't mean is to break the system in the present so that taxpayers in the future will have it easier, which is what we're doing now. I guess there's a certain nobility in suffering now so that our children won't suffer in the future, but our children also attend the schools where pension costs are displacing spending on books.

So as you read the moaning about the state deficit this year — and there's going to be a lot of it — remember that a simple fix like adjusting the pension payment schedule is considered off the table. And also remember that, counting the capital gains cuts and the tax rate cap, we're going to give somewhere around $50-60 million in income tax breaks to our wealthiest citizens. Now go read those headlines about cutting state services again and see what you think.

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